Aviation Insider

PwC Aviation Newsletter, October 2021

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The First Year of China's 14th Five Year Plan: Aviation finance and leasing policies at a glance

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Background

The year 2021 marks the first year of China's 14th Five-Year Plan (FYP). Under the guidance of the national-level development blueprint of the 14th FYP (2021-2025) and the outline of Vision 2035 of the National Economic and Social Development of the People's Republic of China (Outline of the 14th FYP), Chinese governments at all levels are actively promoting the formulation of the 14th FYP in various localities and sectors.

We will focus on the aviation finance and leasing industry as laid out in China's 14th FYP, and briefly review the major existing Chinese policies in aviation finance and leasing industry. With reference to the aviation footprint map, it becomes apparent that aviation sector policies have been seeded all across mainland China. Most of the policies currently focus on the bonded leasing structure, with Chinese airline lessees comprising the target market. (Please refer to Aviation Insider Issue 6 "Transferring Old Aircraft from Mainland China to Hong Kong SAR" for a brief introduction to this business model.) In this article, we will review the development of some of the most representative geographical leasing industry regional economic clusters -- Tianjin Dongjiang, Shanghai Lin-gang, Guangzhou Nansha and Hainan for aircraft finance and leasing.

Tianjin Dongjiang

The leasing business in Tianjin Dongjiang Free Trade Port Area (Tianjin Dongjiang) has grown in the past decade into the principal and largest hub for leasing enterprises and assets in mainland China. Over the years, it has also maintained its position as the national leader in financial leasing. The past and continued robust growth of Tianjin Dongjiang could not have occurred without the facilitation policies, nor the smooth and professional implementation and administration of these policies.

Main policies related to the current aviation finance industry

- When China's State Administration of Foreign Exchange in August 2015 approved the collection of foreign currency rent for operating leases, Tianjin Dongjiang became the first area in mainland China to implement the policy.
- Project companies (SPVs) registered in Tianjin Dongjiang under their financial leasing parent companies, which are also registered in Tianjin Dongjiang, may share the foreign debt quota of their parent company. This increases the quota of foreign currency that the project company/SPV can borrow in practice.
- Since 2018, Tianjin Dongjiang has signed a memorandum of "Joint Supervision" with over 10 customs agencies across China. This supports airlines importing leased aircraft directly to the airline's location, optimises the import process for leased aircraft, and significantly saves the labour and cost of flight transfers. Moreover, Tianjin Dongjiang has also extended the supervision of big-ticket leasing equipment to cover high-value aviation parts such as engines and simulators.

New policy developments and their relevant impact on the aviation finance industry

As per the Tianjin 14th FYP and the goals of Vision 2035 as released by the CPC Tianjin Municipal Committee, Tianjin is to undertake key national strategic tasks including promoting the coordinated development of the Beijing-Tianjin-Hebei region, and serving "One Belt, One Road" construction. Its unique location, industry, port, transportation and other advantages afford Tianjin unique opportunities for its development. Tianjin's aviation sector is expected to achieve breakthroughs and innovation in the following ways:

- By building a system of institutional policies for the free flow of investment, trade, finance, people, data, transportation and other factors across borders, Tianjin expects to learn from international first-class free trade ports (zones) and high-standard international economic and trade rules, and continuously explore innovative reforms;
- As the northern shipping center and financial leasing asset-hub, it has also achieved substantial development goals in its bonded research and development, bonded maintenance and other international trade business. Tianjin's offshore, cross-border and other financial innovation businesses are also forecast to gradually develop along with market demand.

Shanghai Lin-gang

The Lin-gang New Sub-zone of the China (Shanghai) Pilot Free Trade Zone (Shanghai Lin-gang) is situated in the southeast of Shanghai, with Pudong International Airport to the north and Yangshan International Hub Port (the world's largest container port) to the south. In the future, Lin-gang will also be the northern end of the Hangzhou Bay "Cross-sea Channel", located in the middle of the coastal channel of Jiangsu-Zhejiang-Shanghai, and it will become a vital hub node in the Yangtze River Delta Bay Area.

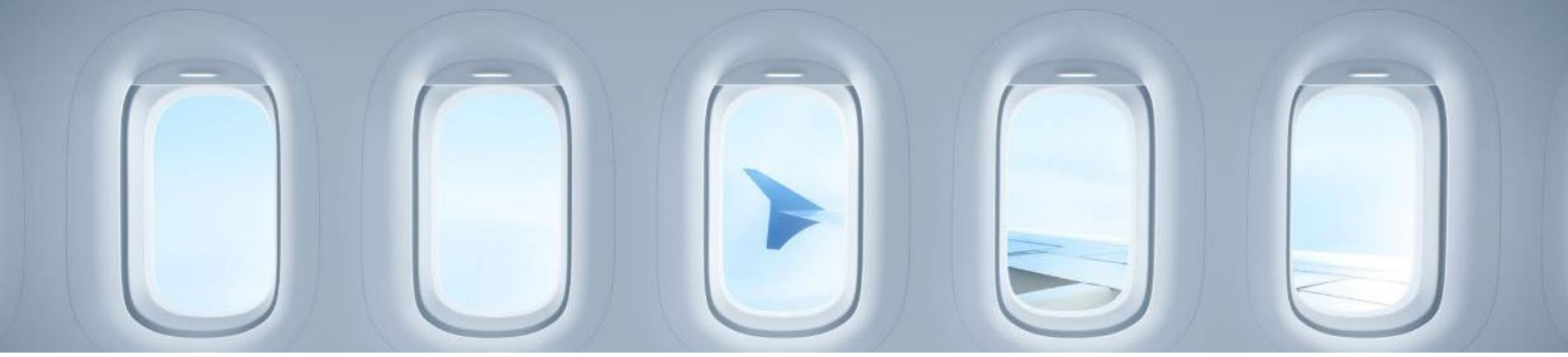
Main policies related to the current aviation finance industry

- Aircraft, ships, large offshore equipment and production equipment imported by key enterprises via financial leasing may not actually enter or leave the sub-zone. Customs shall conduct bonded supervision and implement the mode of off-site supervision by local customs.
- Financial leasing enterprises registered in the sub-zone can conduct operating leasing business and collect rent in foreign currency.
- Eligible pilot enterprises only need to apply for foreign debt registration once within their quota, without the need to apply for signature, withdrawal, change and cancellation registration on a one-by-one basis. They may also borrow foreign currency multiple times within a one-off foreign debt registration quota and circularly use foreign debt funds, as well as borrow from different overseas entities.
- The financial leasing parent company and its subsidiary registered in the sub-zone can share the foreign debt quota.
- The newly established aircraft, ship and large equipment special purpose vehicles (SPVs) in the sub-zone will be subsidised based on their annual comprehensive contributions.

New policy developments and their relevant impact on the aviation finance industry

Shanghai is further promoting the Shanghai-Hong Kong ship and aircraft leasing industry to enhance the cooperation of capital and financial markets, including:

- Encouraging its key financial leasing companies to broaden their financing channels via banks and other financial institutions in Hong Kong SAR.



- Taking the aircraft and ship leasing business as a leading example, Shanghai is to actively explore innovative measures of interconnectivity between Shanghai and Hong Kong SAR in foreign exchange trading, custodianship and settlement. It will also explore establishing a green channel for foreign exchange management between Shanghai and Hong Kong SAR, creating new highlights of financial cooperation between Shanghai and Hong Kong SAR.

- Shanghai Lin-gang has set up many industrial development funds, including a shipping industry development fund. Along with the recovery of the international air transport industry in the post-pandemic era, the sub-zone intends to make full use of the advantages of Hong Kong SAR, the mainland and overseas markets to set up specialised industrial investment funds and forge a place for the growth of the financial leasing industry clusters.

Guangzhou Nansha

Nansha New Area of the China (Guangdong) Pilot Free Trade Zone (Guangzhou Nansha is also the southernmost administrative region of Guangzhou, the capital of Guangdong Province, and the borders of Shenzhen and Zhongshan cities. It lies at the geographical center of the Guangdong-Hong Kong-Macao Greater Bay Area. Guangzhou Nansha is about 30 minutes away from central Hong Kong by high-speed rail and 80 minutes by ferry (60 minutes to Hong Kong International Airport). The drive from Guangzhou Nansha to Shenzhen Bao'an International Airport will be reduced from 60 minutes to about 20 minutes after the Shenzhen-Zhongshan Bridge is completed and opened to traffic (scheduled for 2024).

Main policies related to the current aviation finance industry

- Although Guangzhou Baiyun International Airport is not located within Guangzhou Nansha, the bonded import of aircraft in Guangzhou Nansha can be realised through off-site declaration and supervision linkage mechanism of the customs of Guangzhou Nansha and Guangzhou Baiyun International Airport.

- A series of financial incentives and support are provided for platform companies and project companies conducting aviation finance business in the new area.

- VAT for financial leasing enterprises can be filed on quarterly basis (instead of monthly).

New policy developments and their relevant impact on the aviation finance industry

From the 14th FYP for the Development of China (Guangdong) Pilot Free Trade Zone, it has been proposed the Guangdong Pilot Free Trade Zone should focus on the development of specialised financial industries, including the growth of financial technology, shipping finance, financial leasing and other specialised finance, and collaborate with Hong Kong SAR and Macao to build a global aircraft leasing center.

Although the proposed policy innovation such as – striving for withholding tax exemption under "lease-in lease-out" structures executed by financial leasing companies in the zone with Hong Kong aircraft lessors, among other lists of proposed policy innovation in the Draft for Pubic Consultation are not specified in the finalised 14th FYP for the Development of China (Guangdong) Pilot Free Trade Zone, these are high expectations as to the development of innovative aviation finance policies to facilitate the collaboration between Guangzhou Nansha with Hong Kong SAR given the opportunities created under the Greater Bay Area strategy and the cooperation mechanisms implemented between Guangzhou and Hong Kong SAR including, for example, in April 2021 Guangzhou Nansha and Hong Kong SAR having established a cooperative advisory committee, a think tank initiated by Mr. Leung Chun-Ying (vice-chairman of the CPPCC National Committee).

Hainan Free Trade Port

Hainan, China's second-largest island and its largest special economic zone, is the only province in China that is completely located in the tropics. However, its popularity is not only due to its climate. Since Hainan was approved as a free trade port in 2018, a series of new policy development guidelines and systems, including the Master Plan for the Construction of Hainan Free Trade Port, were introduced which have triggered an investment boom in Hainan.

Main policies and development directions related to the current aviation industry

Hainan's main investment platforms related to the aviation finance industry are the Haikou Jiangdong New District in the capital of Hainan Province and Yangpu Economic Development Zone in Yangpu Peninsula, in the northwest of Hainan Island. Although Hainan's aviation industry development started relatively late, some recent aviation finance-related policies have also demonstrated Hainan's "characteristics", which will help promote the local development of the aviation finance industry. These policies include:

- Enterprise income tax levied at 15% on enterprises registered in Hainan Free Trade Port and operating substantially in encouraged industries.
- For ships and aircraft imported for transportation and tourism on Hainan Island, the "zero tariffs" positive list management is implemented. The goods and articles under the "zero tariffs" list management are exempted from import duties, import VAT and consumption tax.

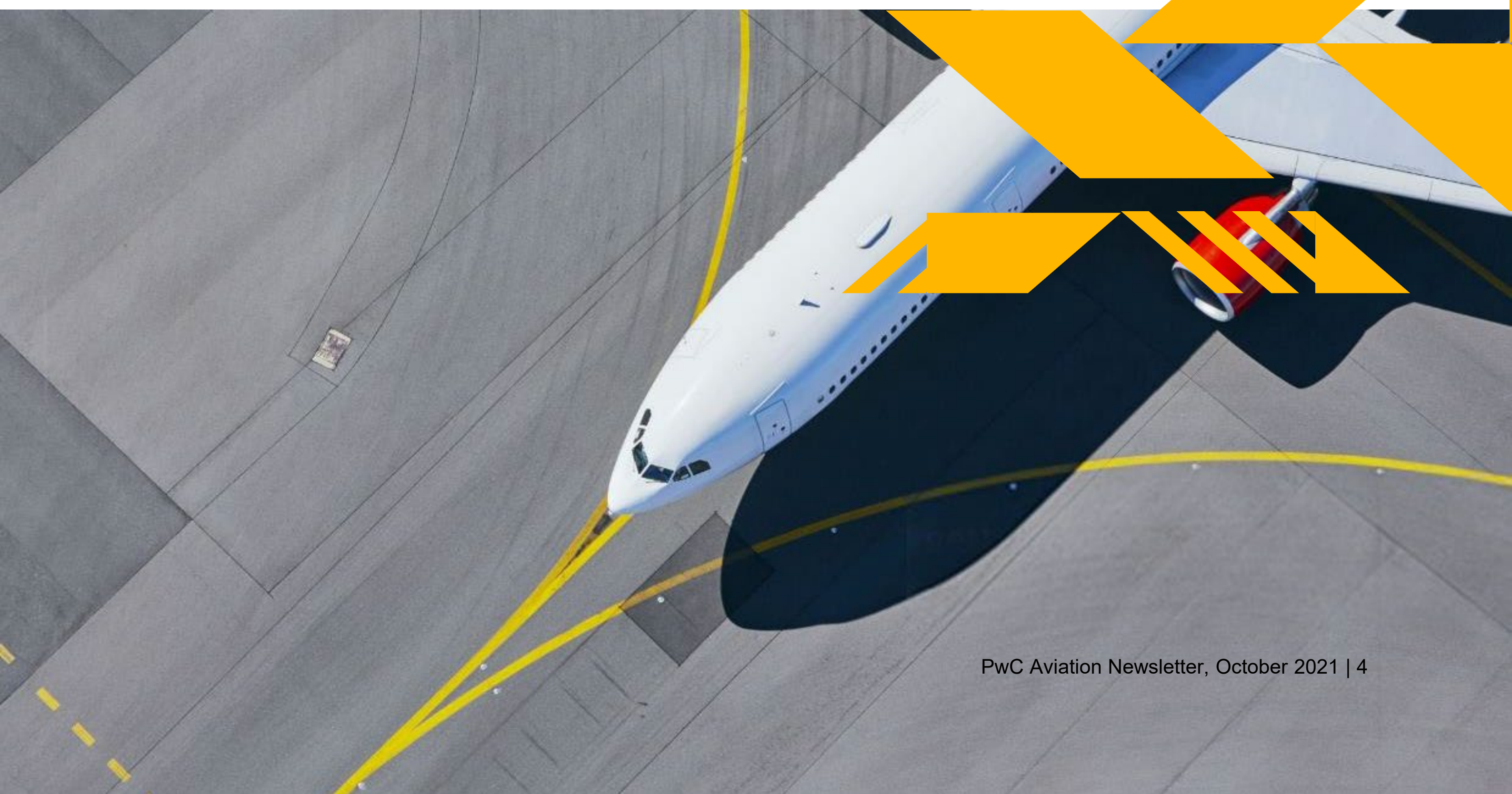
Furthermore, we are following closely on how the "aircraft trading promotion" and the "removal of restrictions on international aircraft financing" mentioned in Hainan's 14th FYP will be further developed and put into practice at the level of specific policy initiatives.

Our observations and conclusions

The aviation finance industry is an indispensable component in the rise of China's aviation industry and an important specialty finance industry, which can be seen through its specific mentions in local governments 14th FYPs across the country. Among these strategic and breakthrough directives on policy innovations, we consider the following to be most worthy of your attention:

- Tianjin Dongjiang's promotion for the growth of offshore leasing
- Deep cooperation between Hong Kong and Shanghai in aviation finance
- Exemption of withholding tax on lease-in lease-out structures between Hong Kong and Guangzhou Nansha
- Hainan's specific policies to promote the development of aircraft trading

We expect the development and progress of the aviation finance industry during China's 14th FYP period, will create a free, more open and convenient business environment for investors.



Update: How will aviation finance groups be affected by the new Irish Interest Limitation Rule?

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The second consultation period in respect of the implementation of the Interest Limitation Rule ("ILR") opened in July 2021 with the publication by Ireland's Department of Finance ("the Department") of the second feedback statement on the topic ("the July Statement").

By way of brief recap, the ILR requires EU Member States to introduce a fixed ratio rule which restricts a company's allowable net interest tax deductions to a maximum of 30% of its taxable EBITDA. This new approach to interest deductibility in Ireland will take effect on 1 January 2022.

The initial consultation period took place during the first quarter of 2021 and saw both the general PwC Ireland Tax team and PwC Ireland Aviation Finance Tax team submit responses to the December 2020 feedback statement ("the December Statement"), as well as supporting the industry led submission by Aircraft Leasing Ireland ("ALI").

The July Statement responds to observations made in various submissions to the Department, and also sets out proposed draft legislative approaches to the ILR provisions as a whole.

There are many positives

At the outset it should be noted that the content of the July Statement is positive in many aspects and comments on many of the issues of relevance for the aviation industry, as set out in both the ALI submission and the PwC Aviation Finance submission, have been taken on board by the Department when compiling the July Statement. The apparent adoption of both the "equity ratio rule" and the "group ratio rule", providing impacted groups with flexibility to limit the restriction, is particularly welcome.

However, certain key areas have not yet been addressed, and as such, this second consultation period will be crucial for ensuring that satisfactory consideration is given to these issues in the ultimate drafting of the legislation.

We comment below on a selection of the key issues in the July Statement.

Interest equivalent implicit in lease rentals

As detailed in Aviation Insider May edition on the rules one of the key issues for the aviation finance industry which was not addressed in the July Statement is the meaning of "economically equivalent to interest".

It has been the view of industry stakeholders throughout the entire consultation process to date, and was set out in the submissions in response to the December Statement, that this is a significant area of concern for lessors, with the view of the industry that part of the operating lease rental income (the implicit interest component) earned by lessors carrying on a trade of leasing aircraft should also be treated as "amounts economically equivalent to interest".

While acknowledging the broadness of the definition of "amounts economically equivalent to interest" included in the July Statement, which should facilitate a favourable interpretation for the industry, given the importance of the issue to the industry and the need for certainty for lessors, specific legislation addressing the issue or, in its absence, clear guidance on the matter, has again been requested during the course of the most recent consultation period.

Aviation Insider May edition

Group ratios offer potential for increased interest deductibility

Positively, the July Statement indicates that both the “Equity Ratio Rule” and the “Group Ratio Rule” may be adopted. The equity or group ratio rule may enable a taxpayer that is a member of a consolidated accounting group to deduct interest expenses in excess of the standard 30% EBITDA limitation, potentially enabling full deductibility where either:

- the equity to assets ratio of the taxpayer is at most 2% less than that for the consolidated accounting group. Or
- the relevant third party interest expense to EBITDA at a consolidated group level is higher than that of the taxpayer.

We expect the adoption of the equity and group ratios will be of significant benefit for many standalone aircraft leasing groups as well as a range of others.

Practical difficulties

However, in order to apply either ratio the taxpayer will need to have a set of accounts prepared for the relevant entity (or group, if the taxpayer intends to apply the rules on a group basis) under the same accounting basis as that of the parent entity. Many groups may not have readily available accounts for Irish entities (or a consolidated Irish group for this purpose) prepared on the same basis as that of the parent. The practical application of the rules could therefore involve significant additional administrative efforts for some taxpayers, with a need to weigh the time and costs involved in this exercise against the potential benefits.

Taxpayers should now review their Irish leasing structures and make an initial assessment of whether the ratios will be of any benefit and, if so, whether it is practical for them to produce the relevant local accounts to avail of that benefit on an ongoing basis.

Notional local group – treatment as a single taxpayer

The July Statement includes an option (individual entities can elect out of any group) and framework for applying the ILR on a local Irish group basis. The adoption of a notional local group approach is particularly welcoming for many in the aviation finance industry, as the application of the measures on an entity by entity basis presents significant administrative challenges and has the potential to increase the tax cost for a group.

PwC Ireland welcomes the notional group option though we have also put forward requests for flexibility in defining the local group. The current definition of an interest group for this purpose is limited to entities which form an Irish corporate tax loss group. To account for various commercially led structuring issues prevalent in the aviation finance industry, we have sought an expanded definition to cover any Irish entities included in a worldwide consolidated accounting group, with an associated request for an ability to form more than one interest group given the commercial needs for such in certain structures.

Exempting "legacy debt"

The approach to the application of the exemption to exclude loans which were concluded before 17 June 2016 from the ILR (the legacy debt exemption) has been amended favourably in the July Statement.

The language in the December draft which could have seen the legacy debt exemption limited to interest arising on principal drawdown under loans pre 17 June 2016, even where a higher principal amount for the loan had been agreed in the loan pre that date, has now been removed. The amended definition alleviates some of the concerns on the practical application of the exemption. However, uncertainty continues for some forms of debt, notably, with loan facilities involving a revolving feature. We have sought clarity on this along with other aspects of the definition in our response as well as our discussions with the Department , with a proposed 12 year sunset clause put forward to allay any concerns with regards to indefinite rolling revolving loan facilities the Department may have, while providing certainty for taxpayers for a set period of time.

Computational issues

The July Statement has completely overhauled the approach to calculating the exceeding borrowing costs and applying the interest deductibility restriction set out by the Department in December.

While we have requested clarity on certain aspects of the calculation, we welcome the revised approach as it is far simpler and removes the application of the Case IV charging mechanism for restricted interest, which was a significant cause for concern for the industry. The positive response from the Department in this regard represents the benefits of the consultation process.

Key takeaways

In our insight released in April, we stressed the limited time remaining to assess the potential impact and consider what options exist to mitigate any negative effects that could arise for your group.

We are now only four months away from implementation of the rules. Most aviation finance groups have conducted their initial assessments at this stage and are refining their views and approach as more clarity is provided. If you have not yet completed that process, the time to do so in advance of implementation is now very limited.

The detail in the July Statement enables a focused assessment of the key issues and potential exceptions / exemptions for most aircraft leasing groups. PwC Ireland can assist you in making this assessment and, where relevant, in applying the PwC Ireland developed ILR analysis tool to better illustrate the potential impact on the corporation tax position of groups in a visual and interactive manner. Reach out to the PwC Mainland China / Ireland Aviation Finance team to discuss and consider your options.

Embracing risks and opportunities in ESG and climate change in the Aviation industry

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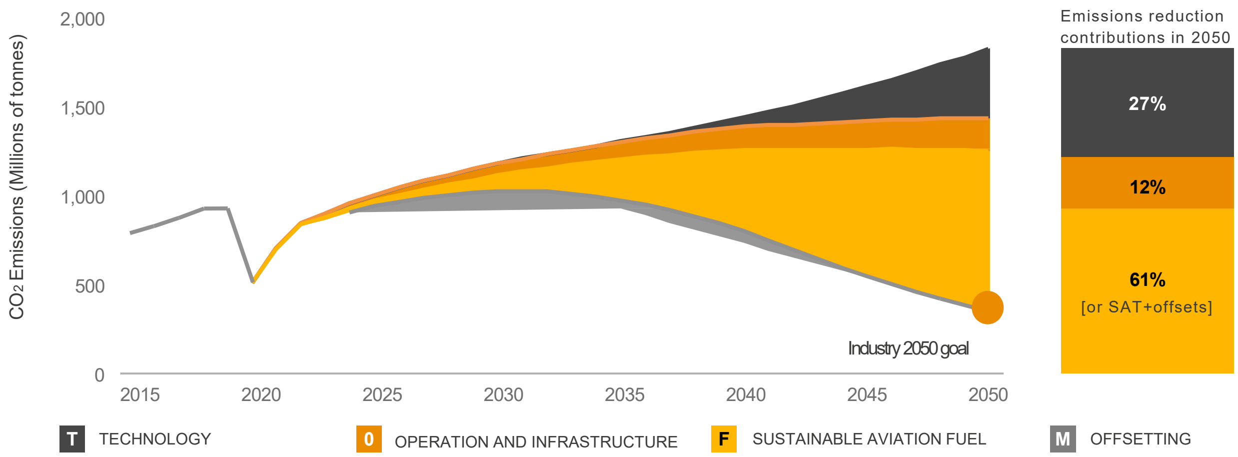
ESG (environment, social, governance) and especially climate change have indeed been a hot topic of late. Nations globally are now stepping up their climate actions and commitments. Aviation, by its nature, is cross jurisdictional and can be subjected to many climate regulations.

Some weeks ago in Europe, we saw the EU Commission launch the "Fit for 55" package of proposals designed to reduce carbon emissions by 55% by 2030. A big component of the proposals is the mandate Sustainable Aviation Fuel (SAF), requiring fuel suppliers to supply SAF for all airlines departing from EU. The requirement starts at 2% in 2025, 5% by 2030 to 32% by 2040 and 64% by 2050. This is a very ambitious policy proposal and will impact the way airlines and stakeholders source and procure SAF in the future. It is also likely to set off a precedence of increased SAF use globally with more and more governments requiring airlines to use SAF.[1]

Over in Asia, China's long awaited Emissions Trading Scheme- the world's largest- began trading in mid-July. The China ETS will be a key initiative to help China decarbonise and be net zero by 2060. Initially covering only the power sector, the ETS is expected to include domestic aviation in the near future.[2]

These additional regional/ domestic regulations complement the global Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) that was agreed by the International Civil Aviation Organisation (ICAO) a few years back. CORSIA covers all airlines and international emissions and requires all airlines to collectively cap the carbon emissions at 2020 levels (so called 'carbon neutral growth'). If the total emissions are above 2020 levels, airlines will then need to purchase either SAF or carbon offsets to compensate for the emissions.



Source: Air Transport Action Group3

1 More info: https://ec.europa.eu/info/sites/default/files/refueleu_aviation_-_sustainable_aviation_fuels.pdf
2 https://icapcarbonaction.com/en/?option=com_etsmap&task=export&format=pdf&layout=list&systems%5B%5D=55
3 https://irena.org/newsroom/articles/2017/Feb/Sustainable-Flight-with-Biofuels

All these new and upcoming policies will likely change the way airlines operate and will require a new approach to this changing landscape. In view of the risks and opportunities of the aviation industry related to ESG and climate change, PwC would like to share the following insights:

1. Good ESG information disclosure directly affects credit rating

The aviation industry relies heavily on borrowing. Historically, when assessing a company's credit rating, lenders have focused on its credit-worthiness. However, more and more domestic and foreign rating agencies have incorporated ESG factors into their credit ratings. On the premise of maintaining consistency with the basic principles of international ESG credit ratings, and fully considering the Chinese characteristics, they have adjusted the corporate governance risk indicators of different management modes to construct a Chinese domestic ESG credit rating system and establish targeted and more comprehensive ESG evaluation indicators.

Integrating ESG into credit ratings can help investors focus on the sustainability of companies, better manage risks and improve investment returns. When evaluating whether the investment target has long-term profitability, investors should focus on the rating of ESG by rating agencies.

A good ESG credit rating can help companies enhance social image boost share price and reduce financing costs. Therefore, companies should improve their ESG information disclosure and strive to improve their credit ratings by understanding ESG credit rating methodology.

2. Process and measures to achieve carbon emission reduction targets in aviation industry

Decarbonising aviation is especially challenging due to the limited alternative technologies available, unlike other transport sectors. In September 2020, the Air Transport Action Group (ATAG) issued their Waypoint 2050 Action Guide document, which outlines the potential path for the aviation industry achieve the goal of zero net carbon emissions by the global civil aviation industry by 2060 or 2065.

The Waypoint 2050 Action Guide mainly include these measures:

Aircraft technology: Gaining fuel consumption and emissions benefits by improving the efficiency of jet engines, operations and also towards electrification of other aircraft components (for example, from landing gear to cockpit control systems, etc.), and indeed the aircraft itself. Airlines should engage in technology discussions as well as embrace technological change, be more receptive to modify their fleet composition as and when necessary. However, technology and operations alone are unlikely to be able to meet the decarbonisation goals themselves, and use of SAF or carbon offsets will be required to complement the efficiency improvements.

Sustainable Aviation Fuel (SAF): Due to the requirement for energy dense fuels, SAF is one of the main ways to decarbonise the sector now and in the future. Energy companies such as PetroChina and Sinopec have invested in R&D, but the high economic cost is a stumbling block that hinders their commercialisation. Therefore, SAF may have difficulty achieving economic benefits in the short term without incentives or partnerships with other stakeholders in the value chain. In order to achieve the purpose of reducing carbon emissions, SAF must be scaled significantly and can be achieved through continued technology development and supported by policies.

Carbon offsetting: Purchase emission reduction certificates from the market can play an important role in meeting the airline's obligation under CORSIA . The prices for carbon emission certificates do vary significantly over time and companies should monitor or consider risk management approaches such as hedging some of their carbon exposure ahead of time.

3. Against the backdrop of increasing domestic and international carbon targets, companies should get ahead of climate regulatory requirements

With the general trend of "**carbon peak, carbon neutral"** goals, improving low-carbon management and carbon emission reductions will be issues that companies must face in their operational processes. Stakeholders related to enterprise production activities -- such as regulators, investors, suppliers and consumers -- also have requirements for carbon information disclosure. **Based on this, airlines may need to gather increasingly granular data and requiring new processes to measure and report on emissions accurately.**

Beyond the data and systems, airlines may also wish to build up the internal capacity to respond to climate regulations. Procurement, finance and senior leadership will need to be involved to better understand their respective roles and responsibilities to ensure pro-active monitoring and development of pathways to compliance.

Getting ahead of the regulations allows the airlines to identify the most efficient approach to address the requirements and also identify areas of improvements and potential for regulatory cost savings as well as mitigation of risk of penalties from non-compliance.

4. Balance between aviation industry development and carbon emission control

China's aviation industry is still in a stage of rapid development, and hence carbon emissions is expected to continue to increase considerably. To promote sustainable development of the aviation industry, the balance between industry development and carbon emissions needs to be considered. In addition to formulating relevant systems for carbon emission statistics, testing, reporting and quota allocation under the overall national carbon emissions reduction plan, the aviation industry can further promote sustainable development from the following aspects:

- Promote R&D and support the application of Sustainable Aviation Fuel (SAF) through policy incentives and mandates
- Setting increasingly aggressive carbon emission standards for aircraft that can be used domestically, which could promote newer and more advanced technology development.
- Consider appropriate carbon pricing mechanisms that will incentivise increasing the efficiency of fleet operations.

Opportunities and the way forward

This changing landscape can also bring about opportunities for airlines. Airlines can develop new greener products and services to attract and engage a new generation of eco-conscious consumers and corporates. SAF also presents a unique opportunity in a fast growing industry with seemingly limitless potential. Some airlines have invested directly into new biofuel technology companies that provides a new growth opportunity as well as access to SAF supply in the future.

How we can help

Climate change presents a key material risk to airlines in the long term, particularly transitional risk as governments and society at large push for the sector to decarbonise.

With the deepening and understanding of ESG and climate change concepts, airlines should consider the relevant impact and countermeasures in their strategies and operations as soon as possible. PwC is committed to providing professional support for companies in strategy formulation, report preparation, decarbonisation and setting climate change targets.

PwC helps companies clarify ESG priorities and optimise investor disclosure reports. For green finance, PwC helps companies incorporate ESG and climate factors into risk management, operations, and decision-making throughout the business sector, assesses the company's resilience to climate change and how to take advantage of opportunities against climate change, improves and redesigns business strategies, operating models and execution methods to make it more sustainable and promote the transformation of corporate strategy.

The impact of the PRC Civil Code on financing and leasing transactions*

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The Impact of the PRC Civil Code on Financing and Leasing Transactions

On 1 January 2021, the Civil Code of the People's Republic of China (the "Civil Code") officially came into effect. Its relevant provisions on security and the accompanying Supreme People's Court Interpretations on the Application of the Civil Code of the People's Republic of China Relating to Security Mechanism (the "SPC Interpretations") made many changes to the pre-existing legal principles under the PRC Security Law and the PRC Property Law, which were repealed simultaneously with the implementation of the Civil Code.

These amendments will have a far-reaching impact on China's domestic financing and leasing transactions as well as cross-border transactions with a Chinese onshore element. This article will explore the impact of the Civil Code and the SPC Interpretations on the security arrangements in financing and leasing transactions, and highlight matters requiring particular attention when designing and negotiating security mechanism that will potentially fall into the ambit of the regime.

In both domestic and cross-border financing transactions, parties will customarily enter into a suite of security or quasi-security instruments, such as mortgages, pledges, guarantees, sponsor's support letters and conditional sale agreements. This article will discuss the impact of the Civil Code on each of these security instruments.

PRC Mortgage

Transfer of mortgaged property

In contrast to the now repealed PRC Property Law, which provided that, during the mortgage period, the mortgagor shall not transfer the mortgaged property without the consent of the mortgagee, the Civil Code now stipulates that the mortgagor may transfer the mortgaged property without the consent of the mortgagee, provided the mortgagee is notified in a timely manner. However, the Civil Code allows the parties to opt out of this provision, resulting in such transfer being prohibited without the consent of the mortgagee.

By the same principle, even without prior agreement the rights of the mortgagee will not necessarily be affected as the Civil Code further requires that timely notice shall be given to the mortgagee when the mortgagor transfers the mortgaged property.

If the mortgagee can prove that such transfer may endanger the security interests constituted by the mortgage, the mortgagee is entitled to require the mortgagor to repay the secured debt or deposit the proceeds derived from the transfer to the mortgagee in escrow.

The portion of transfer proceeds that exceeds the amount of the secured debt will be the property of the mortgagor. On the other hand, any shortfall will need to be made good by the debtor. However, if a mortgage is not perfected, once the property is transferred to a bona fide third party, any recovery of the secured property or proceeds will be very unlikely upon the insolvency of the mortgagor. Therefore, in order to mitigate the risks set out above, it would be prudent for secured creditors to adopt the following measures going forward:

- include an express provision in the mortgage to prohibit the transfer of the mortgaged property without the mortgagee's prior consent; and
- promptly register the mortgage, in order to ensure the mortgagee's priority over any potential bona fide third parties.

Registration of mortgage over movable property

The Civil Code provides that mortgages over movable property will not be effective against bona fide third parties without registration. Before 2019, China did not have a unified movable property mortgage registration system, which invariably made it impossible to register mortgages over certain types of assets, such as aircraft engines. In 2019, China introduced a unified registration system at the Credit Reference Center of the People's Bank of China (the "Credit Center"), which has resolved the issue long troubled financiers of aircraft engines for the registration of aircraft engine mortgages in China.. This has been instrumental in mitigating the potential risk of the mortgagor creating subsequent charges on engine assets beyond the control of the financier.

As such, we recommend that financiers promptly register mortgages over movable assets (apart from the aircraft) at the Credit Center as soon as possible following the execution of the mortgage.

Guarantee

Guarantee liability

The Civil Code stipulates that if the mode of guarantee is not specified or unclear in the contract, the guarantor shall be presumed to assume the liability of a guarantor under a general guarantee. This position deviates significantly from the now repealed PRC Security Law, which provided that the guarantor shall assume joint and several liability with the underlying debtor in the absence of express agreement to the contrary in the contract.

The key difference here is, where a guarantor has liability under a general guarantee under the Civil Code, the creditor will need to enforce its interests against the debtor first, and may only call on the guarantor in the event that the debtor's assets are insufficient to pay off the debt following enforcement procedures (unless the creditor adduces evidence that the debtor's assets are insufficient for repayment of the debt, or that it has lost the ability to repay its debts). However, if the guarantor's liabilities are "joint and several" under the guarantee, the creditor can elect to make a claim against either the debtor or the guarantor (individually or together) in any order.

Although the presumption of the nature of the guarantee has been reversed in circumstances even where it is not clearly set out, there is nothing preventing the parties from stipulating under the contract as to what type of guarantee applies. Therefore, all guarantees should expressly stipulate with clear and unambiguous wording that the guarantee is a "joint and several guarantee", so as to circumvent the Civil Code presumption of general guarantee liability. This ensures creditors will be able to make a claim directly against the guarantor without first having to deal with the debtor.

Guarantee period

The Civil Code stipulates the guarantee period (i.e., the period during which the guarantor undertakes guarantee liability) shall be six months from the date when the underlying debt it purports to guarantee shall be discharged in full, if such guarantee period has not been otherwise agreed or if the agreement is unclear. This is very different from the default position under the repealed PRC Security Law and relevant judicial interpretations, which set such period at two years (in the case of unclear agreement (*约定不明*)) or six months (in the absence of any agreement), which in our view provided better protections to guarantors. The change brought by the Civil Code is aimed at requiring secured creditors to assert their rights in a timely manner. At the same time, the Supreme People's Court has defined "unclear agreement" as follows: "If the guarantee contract stipulates that the guarantor shall assume guarantee responsibility until all debts are paid off, the agreement is deemed to be unclear, and in such case the guarantee period shall be deemed to be 6 months". The wording above (for example, a provision stating that the security period or guarantee period shall continue until the secured or guaranteed liabilities are "repaid in full") is very common in English law governed guarantee instruments, as well as some Chinese law governed guarantees in cross-border financing transactions.

In view of the foregoing issue, it is recommended that, for PRC law governed contracts of guarantee, guarantee periods should be expressly and unequivocally defined to avoid the "guarantee period" being regarded as silent or unclear, and therefore reverting to the six months default position. It is also imperative that secured creditors should actively exercise their rights within the relevant guarantee period.

Transfer of debt

The Civil Code stipulates that if the creditor transfers all or part of the creditor's rights without notifying the guarantor, the transfer has no effect on the guarantor. It goes further by providing that where the guarantor and the creditor have agreed to restrict the transfer, and the creditor transfers the debt without the guarantor's written consent, the guarantor will be released from any guarantee liability to the transferee.

The repealed PRC Security Law did not contain any provisions requiring notification to the guarantor of the transfer of the underlying debt in order for the guarantor to remain liable within the scope of the original guarantee instrument. Compared with the provisions of the repealed PRC Security Law, the Civil Code has included the restriction that in the case of a transfer of creditor's rights (i.e., transfer of debt), the guarantor will only be bound if it has been served notice of such transfer.

In light of the above, if a secured creditor wishes to transfer all or part of the debt guaranteed by a third party, it must notify the guarantor in advance to avoid the guarantor being absolved from its guarantee liability as a consequence. In addition, as required by the Civil Code and the SPC Interpretations, the transferor (creditor) must also notify the borrower of the transfer of debt.

Independent obligation clause

The Civil Code provides that a guarantee contract shall be subordinated to the principal debt contract. Unless it is otherwise prescribed by law, the guarantee contract shall be null and void if the principal debt contract is null and void. It should be noted that this is in stark contrast to the position in the repealed PRC Security Law (which provided that "A contract of guarantee is subordinated to the principal contract. Unless it is otherwise stipulated in the guarantee, it shall be null and void if the principal contract is null and void."). The Civil Code changed the provision from "unless otherwise stipulated in the security contract" to "unless otherwise prescribed by any law". It is thus clarified that a guarantee shall be invalid once the principal debt contract (e.g., the facility agreement in a financing transaction) becomes invalid, with the only exception being where it is otherwise prescribed in any law. Any attempt by contract parties to exclude this provision is not allowed.

The inclusion of a "primary and independent obligation" clause is very common in English law governed guarantees, as well as some Chinese law governed guarantees in cross-border financing transactions. After the enactment of the Civil Code, an independent obligation clause will likely be regarded as void if it is incorporated in a guarantee governed by PRC law.

In light of such change in law, to mitigate the potential risks, it is advisable for an offshore creditor in a cross-border financing transaction involving a Chinese debtor or guarantor to choose English law (or other appropriate foreign law) as the governing law for the guarantee.

Sponsor's support letter

Sponsor's support letters are widely used in asset finance and project finance transactions. In these transactions, a debtor's parent company is often reluctant to provide a guarantee and is only prepared to support the debtor by way of a sponsor's support letter. It should be noted, however, that whether a sponsor's support letter constitutes a guarantee may not be determined solely by the name of the instrument. Under the contractual principles of the Civil Code, if a dispute arises over the nature of an agreement, it should be determined by looking into its content, characteristics and main terms and conditions, and not solely by the name of the document.

The Civil Code provides that, where there is a creditor-debtor relationship and the party who commits to make up shortfalls or provide liquidity support manifests an intention to assume the liability of a guarantor, it may be legally deemed to be a guarantee.

Based on relevant judicial precedents and practical application of principles surrounding the commitments to make up shortfalls or provide liquidity support, a contract of guarantee can be established if the committing party obviously manifests its intention to assume the obligations of a guarantor; otherwise, it would be inappropriate to deem such a support letter as guarantee directly.

Regardless of whether the shortfall commitment or liquidity support constitutes a guarantee, a debt accession or an independent contractual relationship, in a financing transaction, the aim of the secured creditor is to use it as a credit enhancement tool, which would allow it, following an event of default, to have recourse against the commitment provider for payment. Accordingly, the following recommendations have been made:

- if the real intention of the shortfall commitment or liquidity support is that the committing party will repay all debts on behalf of the debtor directly, then the term "guarantee" and the phrase "to pay off debts on behalf of [the debtor]" be expressly and unequivocally stated in the document to clearly indicate that the committing party will assume the repayment obligations;
- to provide for a time limit for the committing party to perform its obligation, and where the committing party fails to perform its obligation upon expiry of the time limit, it would become liable for the breach;
- to provide for the triggering events for making up the shortfalls or providing liquidity support as explicit as possible; and
- to minimise the potential risk, the lender should get comfortable with the committing party's internal authorisation and approval process in relation to the provision of the shortfall commitment or liquidity support.

*This article was first published in Chambers "Aviation Finance & Leasing 2021 Global Practice Guide" to which Rui Bai Law Firm and Tiang & Partners are contributing authors for China and Hong Kong SAR.

PwC field report: PwC China Aviation Finance Innovation Lab launched in the Lin-gang Special Area

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On 21 May, the opening ceremony of PwC China Aviation Innovation Lab and PwC Aviation Finance Seminar was successfully held at Dishui Lake Financial Hub in the Lin-gang Special Area. PwC China, Lin-gang Special Area Administrative Committee and Lin-gang Group jointly organised the event. More than 80 guests from government, aircraft leasing and aviation finance industry and media joined the ceremony and exchanged views on the future of the Chinese aviation finance industry.

Mr. Yuan Guohua, Deputy Secretary of the Party and Work Committee of Lin-gang Special Area, and Secretary of the Party Committee and Chairman of Lin-gang Group and Spencer Chong, PwC China Tax Markets Leader, jointly unveiled the plaque.

Mr. Zhao Yihuai, member of the Party working committee of the Lin-gang Special Area and deputy director of Lin-gang Special Area Administration, pointed out in his remarks that Lin-gang is on the high ground of financial innovation and is poised to bolster new forms of financial services to better serve the real economy. Aircraft leasing is a robust form of integrated development of the aviation and financial industries and plays a key role in fostering the opening up of financial markets and development of “dual circulation”. It is also vital in powering the growth of China’s aviation industry.

Spencer Chong introduced PwC China's Aviation Business Services team, which was founded in 2018 with the mission to provide comprehensive services to the development and innovation of China's aviation industry. Aerospace and aviation are one of the four pillar industries in the Lin-gang Special Area. By setting up the Aviation Finance Innovation Lab in Lin-gang, PwC aims to work closely with the aviation industry, financial institutions and the government to explore new possibilities in both aviation and finance industries, such as new cross-border structures, tax policy breakthroughs, and new financing models.

The ceremony was followed by the PwC Aviation Finance Seminar, a semi-annual PwC aviation event traditionally organised in downtown Shanghai but held in Lin-gang on this occasion. Stella Fu, tax partner of Aviation Business Services gave a presentation on "Tax Considerations for Group Restructuring of an Aircraft Leasing Company". She shared industry insights and practical experiences on the group restructuring of aviation leasing companies that typically takes place along the path of aviation assets specialisation and an IPO.

In a round-table panel discussion themed "A New Model for Aircraft Financing – Mezzanine Financing", PwC and Xiamen Aircraft leasing Co., Ltd. experts exchanged views and insights on the industry practice, tax implication and legal risks and mitigation for aircraft mezzanine financing, a model popular among global aviation players but still quite underused in China. The topic was meant to echo the theme of the PwC China Aviation Finance Innovation Lab and to spark innovation and breakthrough in other similar domains of aviation finance.

What to expect

Chinese policy makers see the development of civil aviation as a national strategic goal, which sets the tone for aviation industry in China. Despite the current disruption in global aviation brought by COVID-19, there is no doubt China's aviation market will continue to gain momentum and domestic demand will grow in the decade to follow. According to the Aviation Industry Development Research Centre of China forecast, a total fleet of 7,576 passenger aircraft will need to be replenished by the domestic market by 2039.

Focusing on Shanghai alone, in a guideline published in early August, Shanghai outlined the further development of strategic emerging industries as well as leading industries during the 14th Five-Year Plan period (2021-2025). Under this guideline, Shanghai will boost self-dependent innovation, industrialisation and serialisation of the civil aviation industry chain and form an industry cluster. The output value of its civil aviation and aerospace industry is expected to reach CNY80 billion by 2025. The guideline also mentioned several key development tasks, including commercialisation of large passenger aircraft (C919), mass production of regional aircraft (ARJ21-700), and R&D of widebody aircraft (CR929), jet engines and avionics systems.

It will not be enough, however, if bets are only made on new market capacity and technology advancements. If China expects to double in market size in the next decade; and China is to emerge as a competitor to Ireland in global aircraft leasing; if COMAC is to develop into a new challenger to break the current OEM duopoly, new business models and policy breakthroughs that are commensurate with the scale of these aspirations will be needed, and more importantly, to make things work.

Airlines want stronger, leaner balance sheets. Investors need more efficient and cheap financing. Leasing companies are looking for an easier remarketing structure. Governments want to break free from the rebate-heavy model for sustainable growth. The need and opportunity for innovation is real and it lies not only in aircraft leasing and financing but almost every aspect of the industry chain. This is the vision of the PwC China Aviation Finance Innovation Lab and mission of the PwC Aviation team.

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